In the Supreme Court of the United States

OCTOBER TERM, 1967

No. ——

UNITED STATES OF AMERICA, PETITIONER

v.

THE DONRUSS COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The district court did not render an opinion. The opinion of the court of appeals (App. 11–22)[1] is not yet reported.

JURISDICTION

The judgment of the court of appeals (App. 22–23) was entered on September 27, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] "App." refers to the printed Appendix to this petition. "R." refers to the printed record in the court of appeals.

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STATUTE INVOLVED

Internal Revenue Code of 1954:

Sec. 531. Imposition of accumulated earnings tax.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000 plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

(26 U.S.C. 531.)

Sec. 532. Corporations subject to accumulated earnings tax.

(a) *General Rule.*—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * * * * *

(26 U.S.C. 532(a).)

Sec. 533. Evidence of purpose to avoid income tax.

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a cor-

poration are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.
(26 U.S.C. 533(a).)

QUESTION PRESENTED

Whether for the tax imposed on accumulated corporate earnings of a corporation "availed of for the purpose of avoiding the income tax with respect to its shareholders" to apply, it is necessary that the corporation have as its "dominant, controlling, or impelling" motive the avoidance of income tax on its stockholders, as the court below held, or whether it is sufficient, as the United States contends, that such a motive is one of the purposes of the accumulation.

STATEMENT

Respondent is a corporation which is engaged primarily in the manufacture and sale of bubble gum and candy, and also operates a farm (R. 9a, 38a, 210a). It was incorporated in 1947 with an initial capitalization of $60,000. Its accumulated earnings and profits amounted to $1,638,708.34 at the end of its 1960 taxable year, and $1,679,315.37 at the end of 1961. During 1960 and 1961 its net profits before taxes were $166,014.61 and $60,154.31, respectively. Current assets exceeded current liabilities by a ratio of more than 8 to 1 in 1960 and 14 to 1 in 1961. (R. 9a, 32a, 34a–36a, 209a–210a.)

Respondent never paid any dividends; its president is the only stockholder (R. 210a).

The Commissioner of Internal Revenue assessed accumulated earnings taxes against respondent for 1960 and 1961 under Section 531 of the 1954 Code. Respondent paid and brought a refund suit. In its instructions to the jury, the district court at several points stated that for the accumulated earnings tax to be imposed, avoidance of taxes on the corporation's shareholder had to be "the purpose" of the accumulations (R. 153a, 168a, 169a, 170a). The government objected on the ground that the failure to explain the significance of the word "the" could lead the jury to conclude that tax avoidance was required to be the sole purpose of the accumulation, rather than one of the purposes (R. 172a–173a, 176a, 186a). The court refused the government's express request that the jury be instructed (App. 17):

> it is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation of earnings; it is sufficient if it is one of the purposes for the company's accumulation policy.

Two special interrogatories were posed. In answer to the first, the jury found that respondent permitted its earnings for 1960 and 1961 to accumulate beyond the reasonable needs of the business. But in response to the second, the jury concluded that respondent had not retained the accumulations for "the purpose" of avoiding the income tax on its stockholder. The result was a verdict and a judgment for respondent. (R. 211a–213a.)

The Court of Appeals for the Sixth Circuit held that the charge was erroneous. But the court refused to hold that the government's requested instruction should have been given. Rather, it held that on a new trial the jury should be instructed that the accumulated earnings tax applies only if tax avoidance was the "dominant, controlling, or impelling motive" behind an excessive accumulation of earnings (App. 16–22.)

REASONS FOR GRANTING THE WRIT

1. The ruling below that earnings accumulated beyond a corporation's reasonable business needs are subject to the surtax only if the "dominant purpose" of the accumulation was to avoid taxes on shareholders conflicts with the decision of four other courts of appeals. The Second Circuit stated in *Trico Products Corp.* v. *Commissioner*, 137 F. 2d 424, 426, certiorari denied, 320 U.S. 799, that it could not "subscribe to the view that the prevention of the imposition of surtaxes must have been shown to have been the dominant factor behind the accumulations." Instead, it accepted this Court's statement in *Helvering* v. *Stock Yards Co.*, 318 U.S. 693, 699, that tax avoidance need only have "induced, or aided in inducing" the accumulations. In like manner the Fifth Circuit expressly refused to find error in the Tax Court's failing to find that tax avoidance "was the primary or dominant purpose." *Barrow Manufacturing Co.* v. *Commissioner*, 294 F. 2d 79, 82, certiorari denied, 369 U.S. 817. The Tenth and Eighth Circuits have expressly ruled that the accumulated earnings tax may be imposed where the proscribed purpose is "one of the determining

purposes" of the accumulation. *World Pub. Co.* v. *United States*, 169 F. 2d 186, 189 (C.A. 10), certiorari denied, 335 U.S. 911; *Kerr-Cochran, Inc.* v. *Commissioner*, 253 F. 2d 121, 123 (C.A. 8).[2]

2. The decision below is inconsistent with the statutory purpose. The views of the Second, Fifth, Eighth and Tenth Circuits are correct. Sections 531 and 532(a) of the 1954 Code impose a special tax on the undistributed income of a corporation which is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders * * * by permitting earnings and profits to accumulate instead of being divided or distributed." Ever since the first modern income tax law, Congress has employed this additional tax to deter the use of corporations as a tax avoidance device. See Income Tax Act of 1913, § II(A) (Subdivision 2), Ch. 16, 38 Stat. 114, 166. Although the ultimate test has always been the subjective "purpose" of the accumulation, Congress from the first recognized the difficulties of proving motive. Therefore, the first income tax act made the accumulation of "gains and profits * * * beyond the

[2] The First Circuit, on the other hand, has suggested that it might accept the Sixth Circuit's "dominant purpose" test. See *Young Motor Co.* v. *Commissioner*, 281 F. 2d 481, 491 (C.A. 1); *Apollo Industries, Inc.* v. *Commissioner*, 358 F. 2d 867, 875–876 (C.A. 1). In *Young Motor*, the corporation did not accumulate, and in *Apollo* may not have accumulated, earnings beyond its reasonable business needs. Section 535(c) of the 1954 Code expressly excludes from the tax whatever part of an accumulation is required by the corporation's reasonable needs. This section did not apply to the tax year in question in *Young Motor*, and is not referred to in the *Apollo* opinion.

reasonable business needs * * * prima facie evidence of a purpose to escape the surtax." *Ibid.*

Since 1938, accumulation of excessive earnings has been "determinative of the purpose to avoid the income tax" unless the taxpayer proved to the contrary. Revenue Act of 1938, § 102(c), Ch. 289, 52 Stat. 447; 1954 Code, Section 533(a). The next year a Congressional committee noted that the purpose of making an unreasonable accumulation nearly conclusive evidence of the prohibited purpose was to require a corporation with such earnings "to prove the absence of *any* purpose to avoid surtaxes" on its shareholders in order to itself avoid the accumulated earnings tax. (Emphasis supplied.) H. Rep. No. 885, 76th Cong., 1st Sess., p. 6 (1939). See *Barrow Manufacturing Co.* v. *Commissioner, supra*; *United Business Corp.* v. *Commissioner,* 62 F. 2d 754, 755 (C.A. 2); Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed., 1966), Sec. 6.02, pp. 218–219.

The result below substantially weakens the presumption based on a finding—such as the jury made in this case—that earnings have been accumulated beyond the reasonable needs of the business, since it permits the corporation to escape the tax merely by introducing testimonial evidence that the accumulations were prompted by one or more subjective reasons in addition to tax avoidance. See *Barrow Manufacturing Co.* v. *Commissioner, supra,* at p. 82. By opening this possibility of escape from the tax, the Sixth Circuit has, as a practical matter, substantially undermined the purpose of the accumulated earnings

tax—"to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable" for income tax on the dividends received at the graduated ordinary income rates. *Helvering* v. *Stock Yards Co., supra,* at p. 699.

3. The applicability of the accumulated earnings tax is a frequent subject of contention between the Commissioner of Internal Revenue and taxpayers, both at the administrative level [3] and in the courts.[4] The conflict among the circuits leaves the Commissioner and taxpayers uncertain of the standard to be applied. Review by the Court is therefore necessary to allow even-handed treatment of similarly-situated taxpayers.

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[3] As of October 31, 1967 there were more than 200 such cases pending at the appellate conference level of the Service. In the first 10 months of 1967, another 200 cases involving the accumulated earnings tax were settled at appellate conferences in the Service. Others—the number is not known—were settled at lower administrative levels. The number of such matters pending at lower administrative levels is not presently known.

[4] At this time a total of 350 cases involving the accumulated earnings tax are pending in the district courts, the Court of Claims, and the Tax Court.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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